

## DOCUMENT RESUME

02619 - [A1712689]

[Department of Defense Procedures to Determine Contractor Compliance with Cost Accounting Standards]. PSAD-77-125; B-39995. June 8, 1977. 5 pp.

Report to Frederick Neuman, Director, Defense Contract Audit Agency; by Richard W. Gutmann, Director, Procurement and Systems Acquisition Div.

Issue Area: Federal Procurement of Goods and Services: Reasonableness of Prices Under Negotiated Contracts and Subcontracts (1904); Accounting and Financial Reporting (2800) .

Contact: Procurement and Systems Acquisition Div.

Budget Function: National Defense: Military Assistance (052);

Miscellaneous: Financial Management and Information Systems (1002) .

A limited evaluation of the adequacy of Department of Defense procedures to determine contractor compliance with cost accounting standards and regulations disclosed numerous instances of contractor noncompliance. Findings/Conclusions: The evaluation was directed toward the work of the Defense Contract Audit Agency, which has basic responsibility for ensuring contractor compliance. In addition to numerous identified instances of noncompliance, some have gone undetected because the Agency does not have adequate controls to ensure that all significant provisions of the standards have been included in the reviews of contractor compliance. The Agency is considering a "control schedule for compliance reviews" which would identify cost accounting standard provisions significant to a particular contractor based on potential for impact on contract costs, and which would significantly improve the planning of compliance reviews. Recommendations: The Agency should proceed with the further development and implementation of the controls needed to assure that sufficient audit coverage is given to contractor compliance with cost accounting standards, rules, and regulations. (DJM)



UNITED STATES GENERAL ACCOUNTING OFFICE

WASHINGTON, D.C. 20548

PROCUREMENT AND SYSTEMS  
ACQUISITION DIVISION

JUN 08 1977

B-39995

Mr. Frederick Neuman  
Director, Defense Contract  
Audit Agency  
Cameron Station  
Alexandria, Virginia 22314

Dear Mr. Neuman:

We completed a limited evaluation of the adequacy of procedures and practices followed by the Department of Defense to determine contractor compliance with cost accounting standards, rules, and regulations. Within the Department, administrative contracting officers are responsible for administering cost accounting standards and determining contractor compliance. Although the final decision regarding contractor compliance rests with the contracting officers, basic responsibility for evaluating contractor compliance was delegated to the Defense Contract Audit Agency as part of its audit activities. Therefore, we primarily directed our evaluation toward the work performed by your Agency. In a separate review, we are evaluating the Department's settlement of noncompliance cases identified and reported by your auditors to the contracting officers.

We examined the work performed by your Agency at three contractors. These contractors were selected because they represented a diversified universe--two were major, large volume suppliers to the Department while one was a relatively smaller supplier. At two of the locations, contracts were administered by the Defense Contract Administration Service offices, while at the other they were administered by an Air Force plant representative office. Further, the two larger contractors were audited on a continuous basis by a resident staff while the smaller contractor was audited on an as-needed basis by auditors assigned to a nearby branch office. The auditors responsible for review of the three contractors' activities were assigned to two different Audit Agency regional offices.

We found that the procedures and practices followed by the auditors have resulted in their identification of numerous

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instances where the contractors were not in compliance with the cost accounting standards. However, some instances of noncompliance have gone undetected because, in our opinion, your Agency did not have adequate controls to insure that all significant provisions of the standards have been included in the reviews for contractor compliance.

Your Agency is considering implementing a procedure which could provide the type of control we believe is essential. As discussed on page 4, we recommend that you further develop and implement the needed controls.

#### DEFENSE CONTRACT AUDIT AGENCY PROCEDURES AND PRACTICES

Your Agency's procedures provide for reviews of a contractor's initial disclosure statement of cost accounting practices and subsequent changes to determine compliance with cost accounting standards. In addition, audits are to be accomplished during the performance period of covered contracts to ascertain that a contractor's practices comply with its disclosure statement and cost accounting standards. The procedures state that a determination of compliance will be made during the auditor's normal reviews of a contractor's incurred costs, price proposal evaluations, and functional audits which evaluate a system or cost account for propriety of charges and equity of allocations. However, the procedures provide for separate audits to determine compliance when there are little or no usual audit requirements for a particular contractor.

The auditors had identified and reported 30 instances where the 3 contractors were not in compliance. Noncompliance was found most frequently with respect to Standards 401, Consistency in Estimating, Accumulating and Reporting Costs and 402, Consistency in Allocating Costs Incurred for the Same Purpose. The auditors identified 14 instances of noncompliance during reviews of initial or revised disclosure statements and 7 instances of noncompliance during reviews of contractor proposals. Other noncompliance determinations resulted from reviews of contractor billings, progress payments, projected overhead rates and incurred overhead.

We found that prescribed audit procedures generally had been followed. When the contractors initiated accounting system changes, or new standards were issued, compliance was ascertained primarily through reviews of the contractors' published accounting procedures. Evaluations of the contractors' practices to determine compliance were integral parts of all audit efforts.

However, our evaluation of planning for detailed examinations revealed that your Agency did not have a control system that separately identified the extent to which contractor practices had been evaluated for compliance with provisions of the standards. Planning of future audits was accomplished by the auditors considering the magnitude of expenditures, historical audit experience in the specific area, and how recently the particular cost area had been audited. Although this process did consider to some extent the results of prior reviews, it did not assure that sufficient audit work was done to determine whether the contractor fully complied with cost accounting standards, rules, and regulations.

Our review of the detailed audit work for selected standards indicated that the auditors evaluated the contractor's compliance with many of the provisions in the selected standards. However, some cost accounting standard provisions were not addressed.

At two of the contractors we made limited tests of selected accounting practices not addressed by the auditors. We found instances at each of the contractors where existing accounting practices did not comply with the standards. Because of the limited scope of our examination, we did not attempt to measure the significance of the noncompliances.

Your headquarters representatives told us that audit effort was directed to those areas believed to have the greatest potential for cost savings. Further, they said that since effective coverage of the contractor's compliance with cost accounting standards is inherent to this system of planning, it is unnecessary to give it special consideration in the planning process. However, with the increasing number of standards, the possible value of a supplemental management tool to assist in monitoring compliance tests is recognized.

Agency officials showed us a relatively new management control procedure which is being considered by headquarters personnel and is being tested at selected sites. Under this new procedure, the auditor determines which cost accounting standard provisions are significant concerning the particular contractor based on a materiality criterion. A provision is considered material if noncompliance would have a significant impact on Government contract costs or the administrative and audit efforts. Planned audits are reviewed to determine if compliance reviews can be included as a part of these audits. If the compliance reviews cannot be included, separate audits are to be programed. A control schedule will show the planned

review of each cost accounting standard and whether the contractor complied or did not comply with the standard.

### CONCLUSIONS

Your Agency reviews have included evaluations of the contractors' operations for compliance with cost accounting standards, rules, and regulations. This effort has resulted in numerous violations being identified and reported. However, systematic controls to provide for effective evaluation of contractor practices for compliance with provisions of the standards should be improved. Further, our tests of contractor practices revealed noncompliance in areas not addressed by your Agency. Since the audit procedures and practices followed by your auditors were generally prescribed for agency-wide application, we would not expect this situation to vary substantially at other locations.

Your Agency is considering a "control schedule for compliance reviews" which would identify cost accounting standard provisions significant to a particular contractor based on potential for impact on contract costs. This schedule would show the results of audit work accomplished and provide a basis for planning additional work necessary. We believe implementation of this procedure would significantly improve the planning of compliance reviews, providing the criteria established to identify significant standard provisions include all provisions that materially affect the contractor's accounting system.

### RECOMMENDATION

We recommend that you proceed with the further development and implementation of the controls needed to assure that sufficient audit coverage is given to contractor compliance with cost accounting standards, rules, and regulations.

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We would appreciate your comments on this matter and would be pleased to discuss any questions that you may have.

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We are furnishing copies of this report to the Secretary of Defense, Office of Management and Budget, and interested congressional committees.

Sincerely yours,

A handwritten signature in dark ink, appearing to read "R. W. Gutmann". The signature is written in a cursive style with a large initial "R" and a long, sweeping underline.

R. W. Gutmann  
Director